Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
À La Carte and Themed Programming and Pricing	)	MB Docket No. 04-207
Options for Programming Distribution on Cable	)	
Television and Direct Broadcast Satellite Systems	)	

RESPONSE OF THE NATIONAL CABLE & TELECOMMUNICATIONS ASSOCIATION TO STAFF FURTHER REPORT ON À LA CARTE

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TO STAFF FURTHER REPORT ON À LA CARTE

The National Cable & Telecommunications Association ("NCTA") respectfully submits the following response to the "Further Report" of the Media Bureau in the above-captioned proceeding.

KEY POINTS

- In its First Report in November 2004, the Media Bureau concluded that requiring cable operators to make services available on an à la carte basis or "themed tier" basis would make most consumers worse off. The Bureau found that consumers would have to pay more than they pay today to receive far fewer channels – fewer even than the number of channels that they regularly watch, much less the channels that they occasionally watch.

- The Bureau also concluded that à la carte and themed tier requirements would significantly diminish the quantity, quality, and diversity of programming available to viewers. À la carte would cause many program networks to fail – especially networks aimed at minority and niche interests.

- The newly issued Further Report concludes that these conclusions were based on "problematic assumptions" and "incorrect and biased analysis." Relying on alternative hypothetical assumptions, it concludes that "à la carte could be in consumers' best interests." But as we show, with the help of Michigan State University economist Steven Wildman, on virtually every point the assumptions, analysis and conclusions of the Further Report are incorrect, problematic and at odds with the evidence in the record:

- <u>The Further Report identified a computational error in the Booz Allen study on which the First Report relied – but failed to correct it properly</u>. In acknowledging its error in calculating how many à la carte channels customers could purchase without spending more than they do today, Booz Allen also identified for the Commission the <u>two</u> adjustments necessary to correct its error. It showed that once those offsetting adjustments were made, <u>the effects of the error were inconsequential</u>. The Further Report made only <u>one</u> of the necessary adjustments, and therefore it erroneously <u>overstated</u> the number of à la carte channels that consumers would be able to purchase.

- <u>Even the Further Report acknowledges that à la carte only works, if at all, for *digital* services and *digital* customers</u>. The costs of acquiring set-top boxes, when added to increased programmers' costs, would severely reduce the number of à la carte channels that today's *analog* customers – still the substantial majority of all cable customers – could purchase without paying more than they do today. Even under the Bureau's calculations, it's only today's digital customers who could purchase as many as 14 à la carte cable networks without seeing an increase in their monthly bills. For the remaining 60% of cable customers, the costs and disruption of converting to analog would outweigh any benefits.

- <u>The Further Report mischaracterized an important assumption in the Booz Allen study</u>. The Bureau claims it was unrealistic for Booz Allen to assume that cable customers' television viewing would decline by 25% under an à la carte regime. But Booz Allen made no such assumption. It predicted that viewership for currently tiered <u>cable networks</u> would decline by almost 25%, but cable customers might watch more programming on <u>broadcast</u> television stations or premium channels.

- <u>The Bureau's analysis ignores the value of channels that are only watched occasionally</u>. Even if <u>some</u> customers could pay less under à la carte to receive the same numbers of channels that they <u>regularly</u> watch today, they would still lose the ability to view <u>occasionally</u> any of the other channels that are currently available to them today – and to find <u>new</u> favorite channels for regular viewing. Accepting the Bureau's calculations, à la carte would allow some viewers to get as many as 14 channels for the same price they pay for as many as 150 today. The FCC's new report does not account for the value to consumers of this lost ability to "graze" and occasionally view the diverse array of channels on the basic and enhanced basic tiers.

- <u>The Further Report ignores the evidence on the effects of à la carte on advertising revenue</u>. The Further Report challenges the First Report's conclusion that à la carte would result in reduced advertising revenues, which would in turn raise subscription fees, reduce program quality and/or threaten viability of some networks. It hypothesizes that advertisers do not pay much for potential viewers who do not regularly watch a network, and that they might in fact pay more to reach viewers who had affirmatively chosen to purchase the network. The Further Report, however, offers mere conjecture to support this proposition. In contrast, the First Report's assumptions were based on interviews, testimony and other evidence from the advertising community.

- The Further Report ignores evidence confirming the obvious effects of à la carte on marketing costs. Again citing no evidence in the record or elsewhere, the Further Report challenges the First Report's conclusion that à la carte would significantly raise marketing costs for most program networks, compounding the effects of reduced advertising revenues. The Further Report fails to acknowledge that the costs of persuading viewers to *purchase* a program network far exceed the costs of persuading them to *watch* a network that is already available to them. Record evidence in the Bureau's proceeding confirms that marketing costs would be far greater in an à la carte environment.

- The Bureau's economic theories are at odds with the expert economic testimony in the record. The Further Report cites economic theories and articles that suggest that "bundling" is not always beneficial to consumers and that there may be economic benefits that consumers could theoretically gain from à la carte. But it ignores the economic studies submitted by many commenting parties and the testimony of four independent academic economists who appeared at the Bureau's à la carte symposium. Those studies and the economists' testimony virtually all confirmed that in this particular marketplace, the costs to consumers of mandatory à la carte would almost certainly outweigh any benefits.

- The Further Report confirms that à la carte will likely diminish diversity and minority-interest programming – but views this as beneficial to consumers. The Bureau acknowledges that bundling gives cable operators incentives "to add niche programming that appeals to a small set of subscribers rather than add additional mainstream programming that provides greater total value to consumers" and that, in contrast, à la carte would be likely to provide more "mainstream" programming and less "niche" programming. The Bureau views this as a *good* thing because, from an economist's perspective, it maximizes the "total value to consumers." Hundreds of commenting parties who feared the loss of programming uniquely targeted at the interests of minorities – in particular, minorities whose ability to pay for such programming on an à la carte basis might be insufficient to support it – disagree profoundly with the Bureau about the desirability of such a result.

INTRODUCTION

Two years ago, in response to requests from members of Congress, the Commission initiated an inquiry into the feasibility and effects of making programming services available to cable and satellite customers on an à la carte or "themed tier" basis. The Commission received almost 400 comments from cable operators, DBS providers, program networks, consumer groups, government officials, interest groups, consumers and other interested parties.

Several parties submitted studies and analyses by economists and others with expert knowledge of the video and advertising businesses. In addition, the Media Bureau conducted an all-day symposium at which several industry representatives – as well as four independent academic economists – discussed their views and responded to questions.

On November 18, 2004, the Media Bureau issued its 96-page "Report on the Packaging and Sale of Video Programming Services to the Public" ("First Report"). That report identified and discussed both the benefits and the harms – theoretical and real – associated with the bundling of program networks into large basic and enhanced basic tiers. Based on the array of evidence and expert analysis in the record, the Bureau concluded that any benefits were likely, in the real world, to be outweighed by the harm to consumers.

In particular, the Bureau concluded that mandating à la carte or themed tier offerings would be likely to increase costs for cable operators and program networks, result in higher bills for customers who chose to purchase more than a small handful of networks, and cause many program networks – especially those that serve niche and minority interests – to fail, adversely affecting the diversity of programming available for viewing. Consumers would pay more than they pay today to receive fewer services than they currently receive – fewer even than the number that they *regularly* watch today, and far fewer than they have available for occasional viewing. And the quality and diversity of programming available for purchase would be significantly diminished.

Throughout its report, and in an "Economic Appendix," the Bureau explained why it reached these conclusions. It cited and evaluated information and predictions provided by cable operators and program networks, economic studies, and the testimony of the independent economists and others at its symposium. It cited articles and evidence gleaned from news reports and other secondary material. And it cited articles in the economic literature.

The Bureau's conclusions were wholly consistent with the symposium testimony of the four independent economists. Those economists unanimously agreed that because of the structure, economics and technology of the cable marketplace, à la carte was highly unlikely to make consumers better off and was likely to make most consumers worse off. The Bureau acknowledged that, as a matter of economic theory, bundling of goods and services does not always enhance consumer welfare and in some cases may harm consumers. But it concluded – as did the four economists – that in this particular marketplace, there was little reason to believe that consumers would benefit from requiring unbundled à la carte or themed tier offerings.

These conclusions were also consistent with other recent independent studies of the likely effects of à la carte, including a report by the General Accounting Office,[1] an analysis by Bear Stearns,[2] and a study by Kagan Research.[3] Although it was wholly reasonable for policymakers to wonder whether à la carte offerings might enable consumers to save money by purchasing

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1 General Accounting Office, Issues Related to Competition and Subscriber Rates in the Cable Television Industry, GAO-04-8, Report to the Chairman, Committee on Commerce, Science, and Transportation, U.S. Senate (October 24, 2003).

2 "A La Smart?," Bear Stearns Equity Research Report, Mar. 29, 2004, http://www.ncta.com/a_la_carte/bear_stearns_a_la_smart.pdf

3 "Á la Carte Pricing Makes Great Theory, But TV Ch. Bundling Tough To Beat," Kagan Insights, Dec. 15, 2005, http://www.ncta.com/a_la_carte/Kagan-Insights-12-15-05.pdf.

programming on an individual network basis, the cumulative evidence and research has shown that in terms of price, program quality and availability, and diversity, à la carte was likely to have only adverse effects on most consumers.

Now, however, barely a year after issuing its Report, the Bureau has issued a "Further Report" largely repudiating its previous conclusions. In its Further Report, the Bureau claims that its previous analysis "relied on problematic assumptions and presented incorrect and biased analysis."[4] It now concludes that "many consumers *could* benefit from the ability to purchase network programming on an à la carte basis."[5]

The Further Report fails, however, to substantiate this conclusion. Its only example of "incorrect" analysis is an error made by Booz Allen Hamilton, relied upon in the First Report, in calculating the number of cable networks that cable customers could purchase on an à la carte basis without having to pay more than they currently pay to receive the entire basic and enhanced basic tiers of programming. But this error, which Booz Allen acknowledged in a letter to the Commission's Chief Economist,[6] does not significantly alter the ultimate conclusions of the First Report.

Even the Bureau's "corrected" calculation still shows that most customers – including all of today's analog customers, who constitute more than 60% of cable households – would be able to purchase fewer channels than the number that they *regularly* watch today. Today's digital

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4 Further Report, ¶ 2.

5 *Id.*, ¶ 5 (emphasis added).

6 Letter from John Frelinghuysen, Vice President, Booz Allen Hamilton Inc., to Dr. Leslie Marx, Chief Economist, Federal Communications Commission (Dec. 16, 2005).

customers – the only theoretical beneficiaries of the Further Report – could purchase no more than 14 cable channels for the price that they pay today.[7]

In any event, the Bureau's correction was itself methodologically flawed and incomplete. Had the Bureau made the appropriate correction, its calculation would have confirmed that virtually *any* customers who wanted to purchase as many channels as the average customer regularly watches today would have to pay more than they currently pay for the entire basic and enhanced basic tiers.

Moreover, while purporting to challenge the Bureau's conclusions regarding the effects of à la carte on diversity of programming, the Further Report concedes that one likely effect would be, as the Report put it, the "weed[ing] out"[8] of program networks that appeal to minority and niche viewers unable or unwilling to pay enough to support that programming on an à la carte basis. The Further Report suggests that there might be countervailing benefits, insofar as there might be more "mainstream" programming that is more valuable to a larger number of consumers.[9] Even if this were true, this "benefit" would not erase the fact that diversity will be diminished by an à la carte requirement, as the First Report concluded and as hundreds of commenting parties feared.

The Further Report observes that the conclusions in the First Report are based on assumptions of how cable operators, cable program networks, advertisers and consumers would behave in an à la carte environment. And it correctly notes that "using a different set of assumptions, the results *could* be significantly different."[10] But the assumptions that the Bureau

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[7] *See* Further Report, ¶ 14.

[8] *Id.*, ¶ 49.

[9] *Id.*, ¶ 70.

[10] *Id.*, ¶ 8 (emphasis added).

relied upon in its First Report were not plucked from thin air. To the contrary, they were based on *evidence* and *testimony* in the substantial record compiled in the Bureau's proceeding. Virtually *every* assumption was supported by citations to evidence in the record.

In contrast, virtually *none* of the alternative assumptions that "could," according to the Further Report, significantly alter the conclusions of the First Report are supported by citations to anything in the record. Different assumptions may lead to different results – but there is ample evidence for concluding that the assumptions relied upon in the First Report are valid, while the hypothetical alternatives put forward in the Further Report are based on nothing but unsupported conjecture.

Similarly, the Further Report, relying on economic literature, claims that the First Report's analysis of the economic costs and benefits of à la carte overemphasizes the costs and fails to recognize that "bundling" of goods and services can have costs as well. But the Bureau, in its First Report, acknowledged the fact that bundling can, in various circumstances, have both costs and benefits. It simply found that, taking into account the unique circumstances of the multichannel video programming marketplace, *the benefits of bundling significantly outweigh the costs*.

This is a conclusion supported by the four economists at the Commission's symposium. NCTA has asked one of them – Professor Steven Wildman of Michigan State University – to further explain why it is so, and also to examine the assertions, assumptions and conclusions in the Further Report. Professor Wildman's paper, attached to these comments,[11] provides an

[11] S. Wildman, "A Case for À La Carte and 'Increased Choice'?: An Economic Assessment of the FCC's Further Report" (2006), attached to this Response as Attachment A.

economic analysis of the Further Report and confirms that its criticisms of the First Report widely miss the mark.

After examining the Further Report's critique of the computational errors and biased and problematic assumptions that supposedly permeated the First Report, Professor Wildman finds that the Further Report has not "advanced any credible arguments on behalf of a policy-mandated shift to à la carte, mixed bundling, themed tiers or subscriber-selected tiers."[12] He concludes that:

> As with motherhood, patriotism and the American way, it is difficult to argue against a proposal that promises to give consumers more choice. This, of course, is exactly why policy proposals cloaked in such terms merit more than usual scrutiny. This report applied such scrutiny to the cases for à la carte and the other pricing policies advanced in the Further report and found that *they do not stand up to close examination*. [13]

I. THE SINGLE "MISTAKE" IDENTIFIED BY THE FURTHER REPORT DOES NOT SIGNIFICANTLY AFFECT THE FIRST REPORT'S CONCLUSIONS

Relying on a Booz Allen Hamilton analysis submitted by NCTA, the First Report concluded that under an à la carte regime, consumers would only be able to purchase "fewer than 9 program networks" (*i.e.*, fewer than the 11 that the average customer regularly watches, and far fewer than the number currently available for occasional viewing) for the same amount that they currently pay today.[14] In testimony before the Senate Committee on Commerce, Science and Transportation on November 29, 2005, Chairman Martin announced that he had asked the Media Bureau and the Chief Economist to reexamine the First Report and that they had spotted an error in the Booz Allen study on which the First Report had cited in support of its conclusions:

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[12] Wildman at 28.

[13] *Id.*, at 29.

[14] First Report at 6.

> The report relies on a study that makes mistakes in its calculations. For example, the report fails to net out the cost of broadcast stations when calculating the average cost per cable channel under à la carte pricing. As a result of this mistake, the report understates the number of cable channels a consumer could purchase under à la carte pricing without seeing an increase in their bill.[15]

In a December 16, 2005 letter to the Commission's Chief Economist, representatives of Booz Allen acknowledged the error in its initial analysis and provided the FCC with the appropriate corrections. As Booz Allen explained, *two* adjustments needed to be made to its calculations of (1) the price per channel at which operators would be expected to offer à la carte service in order to maintain the current average revenue per user, and (2) the number of previously tiered channels that the average consumer would be able to purchase on an à la carte basis without having to pay more than they pay to receive the current tiers:

> Specifically, as Chairman Martin's statement suggested, revenues from the broadcast basic tier should have been excluded from the operators' video average revenue per user (ARPU) before calculating the average cost per channel under à la carte. *And* those revenues, along with revenues from premium, pay-per-view and video on demand, should also have been excluded in calculating how many à la carte channels the average consumer could purchase before facing an increased monthly cable bill.[16]

The Further Report, erroneously, only makes the first adjustment. It correctly excludes the broadcast tier revenues from the calculation of ARPU and average à la carte price per channel. But inexplicably it does *not* exclude those and other extraneous revenues in deriving how much money consumers would be able to spend specifically on à la carte channels without having to pay more than they do today. As a result, it pads the amount of cash available to purchase à la carte channels and so mistakenly concludes that consumers could purchase

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[15] Oral Statement Before the Senate Committee on Commerce, Science and Transportation, "Open Forum on Decency," November 29, 2005, p.4, http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-262484A1.pdf.

[16] Letter from John Frelinghuysen to Dr. Leslie Marx, *supra* note 6.

between 10 and 14 channels without spending more than they spend today to receive tiered services.

As the Booz Allen letter showed, had the Bureau made *both* necessary corrections, it would have found that the average analog customer would be able to purchase only 6 to 8 à la carte channels, while even digital customers (who already are paying for digital boxes today) would be able to purchase only 8 to 10 cable channels. Thus, as Booz Allen noted in its letter, the corrections, if properly made, would not change the underlying conclusion of the initial analysis: "Under all of the scenarios evaluated, consumers would be able to purchase fewer than the 11 cable channels that they regularly watch today, for the same price that they currently pay to receive the entire basic and expanded basic tier."[17]

The Further Report repeatedly cites the Booz Allen letter's concession that a mistake had been made.[18] But the Further Report does *not* explain why it failed to make *both* the adjustments that Booz Allen identified as necessary to correct the mistake. Bottom line: The technical mistake that the Further Report identifies in the initial Booz Allen study does not, when properly corrected, undermine or alter the conclusions of the First Report.

Even if the Further Report's own "correction" of the mistake were methodologically sufficient, it would show only that *some* cable customers – specifically *digital* customers – could pay less than they do today and still receive more channels than the *average* cable customer watches *regularly* today. The number of these à la carte beneficiaries would likely be a small minority of viewers. That's because digital customers currently represent only 40% of the cable universe, and not all television sets in those homes are equipped with digital boxes.

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[17] *Id.*

[18] Further Report, ¶ 3 n.4; ¶ 6 n.8; ¶14 n.19.

But more to the point, digital customers, who typically receive over 150 channels, almost certainly want to receive more than the 11 cable channels that the average customer watches with regularity. That's why many choose to purchase digital service. Digital customers incur the additional cost of digital set-top boxes and the additional price of the digital tier in order to receive more viewing options than the 70 channels that are already available to analog customers. Whether they watch these additional channels regularly or simply want the option to watch them occasionally, it is unlikely that digital customers would view the ability to purchase 14 channels for the same price that they now pay to receive 150 channels as a significant "benefit."

Even if it were the case that *all* customers could pay less to receive the same number of channels that they regularly watch today, they would still lose the ability to view occasionally any of the other channels that are currently available to them today. The FCC's new report does not account for the value to consumers of this lost ability to "graze" and sometimes even find *new* channels for *regular* viewing But most customers will, in fact, pay *more* to receive the same number of channels that they regularly watch today, wholly apart from losing all those occasionally viewed channels. As Professor Wildman confirms, only by "failing to acknowledge the full correction identified by [Booz Allen], which left its original conclusions basically unaltered,"[19] does the Further Report reach a different conclusion.

[19] Wildman at 2.

II. THE ASSUMPTIONS UNDERLYING THE FIRST REPORT'S ANALYSIS WERE BASED ON FACTS, EXPERTISE AND RECORD EVIDENCE

The Further Report challenges many of the assumptions underlying the First Report's conclusions. It speculates, for example, that viewership may not decline as precipitously as the First Report predicts. As a result, it contends, advertising revenues might not be adversely affected by an à la carte mandate – and might even increase. It hypothesizes that programmers' marketing costs might not have to increase as sharply as predicted. And, if advertising revenues are higher than projected and marketing costs are lower, then the effects on programmers will not be as severe as projected: license fees need not increase, expenditures on quality programming need not decline, and the projected failure of many new and diverse program networks need not occur.

These sanguine conclusions are all based on assumptions contrary to those relied upon in the First Report. But unlike the assumptions relied upon in the First Report, which were grounded on solid evidence in the voluminous record compiled by the Bureau, the alternative assumptions posited in the Further Report rely on conjecture.

A. The First Report Did Not Assume a 25% Decline in Television Viewing.

The Further Report contends that the First Report's predictions regarding the effects of à la carte on are "suspect" because they are based on the "questionable" assumption in the Booz Allen report that consumers would watch nearly 25% less television.[20] The Further Report makes fun of this assumption, suggesting that "it seems unlikely that the average consumer would spend 2 hours more reading, listening to music, or working per day instead of watching

[20] Further Report, ¶ 3.

television merely because he is no longer required to buy a particular channel of programming."[21]

But that's not at all what Booz Allen said. Booz Allen's prediction was based on an analysis of viewership of cable networks by "heavy viewers" and by "occasional viewers." It stated that if consumers only purchased basic cable networks that they watch most regularly and no longer had access to networks that they now watch occasionally, viewership of *cable networks* would decline, on average, by 23% – even taking into account *increased* viewing of networks by those who chose to purchase them. This does not mean that *total* television viewing would decline so sharply; cable customers may watch more programming on *broadcast* television (which cable operators are required to provide) and on *premium* channels. The Further Report simply misreports what Booz Allen stated.[22]

Furthermore, the Further Report suggests that "if a customer regularly watches only 10 channels and under à la carte continues to subscribe to those 10 channels, one would not expect the time the consumer spends viewing video programming to change dramatically."[23] But even customers who *regularly* watch only 10 cable networks may spend significant amounts of viewing time occasionally watching some of the other dozens of networks available on their basic and enhanced basic tiers. It's not intuitively obvious, as the Further Report seems to assume, that if customers no longer choose to purchase those occasionally viewed networks, all their occasional viewing time will simply be shifted to the 10 networks they regularly watch.

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[21] *Id.*, ¶ 16.

[22] *See* Wildman at 7-8.

[23] Further Report, ¶ 16.

Booz Allen's assumption that only a portion of that occasional viewing time was likely to go to regularly viewed cable networks, and that a significant amount would go to broadcast stations, premium channels, other sources of video entertainment, or elsewhere hardly seems unreasonable. But Booz Allen's assumption, unlike the Further Report's, was based not simply on intuition but on experience, interviews and research on viewing habits. And the assumption was also supported by a multitude of comments and testimony in the Bureau's proceeding. The Further Report cites nothing to support its contrary assumptions.

B. The Further Report Ignores the Evidence on the Effects of À la Carte on Advertising Revenue.

The Further Report challenges the First Report's conclusion that à la carte would result in reduced advertising revenues, which would in turn raise subscription fees, reduce program quality and/or threaten viability of some networks. In doing so, the Bureau also hypothesizes that advertisers do not pay much for potential viewers who do not regularly watch a network; and that they might in fact pay more to reach viewers who had affirmatively chosen to purchase the network.[24]

The Further Report again offers nothing but conjecture to support this proposition. In contrast, the record in the Bureau's proceeding plainly refutes it. Booz Allen based its assumptions that advertising revenues would decline if networks lost the *opportunity* to be viewed by tier subscribers on interviews with the advertising community. Many comments in the record confirmed that this would occur.[25]

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[24] *See* Further Report, ¶¶ 48-49.

[25] *See* First Report at 43-47 and footnotes therein. *See also* Wildman at 9-11.

Moreover, Jon Mandel, Chief Global Buying Office for MediaCom Worldwide, an expert on media advertising who testified at the Bureau's à la carte symposium, confirmed that advertisers rely primarily on *potential* audience and that à la carte, by reducing such potential viewership, *would* seriously diminish ad revenues. In fact, Mr. Mandel was specifically asked by the Chief of the Media Bureau whether, as the Further Notice now suggests, it might be the case that advertisers would actually pay *more* if they knew that a network's audience consisted only of heavy viewers who chose to purchase it – and he specifically dismissed that theory as "false."[26]

C. The Further Report Ignores the Evidence on the Effects of À la Carte on Marketing Costs.

Again, citing no evidence in the record or elsewhere, the Further Report disputes the First Report's conclusion that à la carte would significantly raise the marketing costs for most program networks. The Further Report says that since fewer than half of cable viewers find new channels by "surfing," cable networks must already need to "find ways to advertise their programming to the remaining MVPD viewers."[27] But the marketing issue in an à la carte regime is not the need to persuade viewers to *watch* programming that is already available to them. It is the need to persuade them to *purchase* the network in the first place, so that the programming becomes available to them – and so that cable operators (and DBS providers) will continue to choose to carry them.

Numerous cable program networks filed comments confirming that, for these reasons, their marketing costs would increase – in some cases, to unaffordable levels – in an à la carte

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[26] Symposium Transcript at 61. As Mr. Mandel explained, "We know that subscribers over time will turn into viewers through trial. The key thing that all marketers know is there is no purchase without trial, and there is no trial without availability and shelf space first, and then consumer knowledge of that availability." *Id.* at 66.

[27] Further Report, ¶ 54.

regime. The First Report cited these comments and described at length the experiences and predictions reported by several networks.[28] Moreover, NCTA and the Booz Allen report showed that premium channels (which are offered on an à la carte basis today) spend 15-25% of net sales revenues on marketing, while tiered cable program networks spend only 2-6% on marketing.[29]

Here, the Further Report simply ignores this evidence while providing none of its own. In the face of evidence that cumulatively, unanimously and credibly supports a single conclusion, the Further Report simply speculates on possibilities that "could" or "might" occur. This is not "balance" but a disregard for the notice and comments process upon which administrative agencies must rely.

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In sum, the First Report was on solid ground in concluding that à la carte's decreased viewership, diminished advertising revenues, and increased marketing costs would put pressures on program networks to increase their licensing fees and/or spend less on programming. This would, in turn, result in higher prices for consumers and/or further reductions in viewership, threatening the viability of many program networks. The Further Report's suggestions that the results "could" or "might" be otherwise enjoy no empirical or evidentiary support.

III. IN THE VIDEO MARKETPLACE, THE ECONOMIC BENEFITS TO CONSUMERS OF BUNDLING FAR OUTWEIGH THE COSTS

The Further Report criticizes the First Report's discussion of the economics of bundling as "unbalanced" because it only describes the benefits associated with bundling. According to the Further Report, the economics literature suggests that there can be both benefits *and harms* to

[28] *See* First Report at 48-51.

[29] *See* NCTA Comments at 26.

the bundling of goods and services and that "a change from bundled pricing to à la carte may either increase or decrease economic efficiency, depending on the environment."[30]

As Professor Wildman points out, it is true – but beside the point – that bundling can be more or less beneficial to consumers than à la carte depending on the circumstances.[31] Indeed, *all*

the independent economists who appeared at the Bureau's symposium (several of whose general earlier works – but not their more pertinent symposium testimony – are cited by the Further Report) recognized this truism. But what they also recognized was that *in the particular circumstances surrounding the marketing of video programming networks to cable customers*, mandating à la carte availability is much more likely to be harmful than beneficial.

For example, Professor David Waterman stated that:

> [t]he overall effect of a mandatory à la carte system would really be *pretty disastrous*. I think, first of all, it would have a very negative effect on the advertising market, because advertisers would no longer have very much demand to reach such small audiences....Networks would be more dependent on their affiliate fees, but they … can't just raise their affiliate fees. They have already raised them what they can.[32]

Thus, according to Professor Waterman, "anything that you do to try to force à la carte and less bundling, almost everything you do, has some kind of negative effect, which I think is probably going to swamp other things."[33]

At the symposium, Professor Wildman agreed: "Is it possible to improve over the current situation [with some sort of à la carte regulation]? . . . Off the top of my head, I can't think of

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[30] Further Report, ¶ 26 (footnote omitted).

[31] *See, e.g.*, Wildman at 15.

[32] Symposium Transcript at 208 (emphasis added).

[33] *Id.* at 263.

any way."[34] Professor Wildman agreed that when consumers purchase tiers of program networks "you aren't paying for something you don't want,"[35] although something you don't want may be in the same tier. He explained that bundling "is a way to effectively price discriminate"[36] in a beneficial way that "tends to promote efficiency."[37] Such an approach "tends to increase welfare and is a good thing."[38]

Professor Gregory Crawford provided similar economic explanations, noting, for example, that "there are certainly discriminatory reasons for cable systems to bundle, and … *this may actually enhance the quality and number of cable networks that we see*."[39]

Professor Erik Brynjolfsson elaborated on why this is so in the case of cable television, where the marginal cost of providing cable networks to additional subscribers is very low, even though bundling may be less beneficial when there are higher marginal costs:

> When a good has close to zero marginal cost, the economically efficient thing from an economy-wide standpoint is to make it available to everybody who has it at value greater than zero. So, to the extent that some people are priced out of the market by a positive price, that is a detriment to social welfare, and that tends to happen to a greater extent when things are priced à la carte than when the price is bundled.[40]

Professor Brynjolfsson also confirmed the effects of à la carte requirements on program diversity:

> Disproportionately hurt are the small, not widely watched content channels. When you go to à la carte, their subscriptions and their revenues fall disproportionately. Conversely, when you add them as part of the bundle, they're

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[34] *Id.* at 267.

[35] *Id.* at 188.

[36] *Id.* at 184.

[37] *Id.* at 187.

[38] *Id.*

[39] *Id.* at 256 (emphasis added).

[40] *Id.* at 212.

> the ones that benefit the most. So, going to à la carte is going to disproportionately reduce the amount of product variety and obscure channels or viewpoints that are available as compared to bundles.[41]

As Professor Wildman points out in his attached paper, it's not just that the unique cost factors associated with diminished advertising revenues and increased marketing expenses that decidedly tip the cost-benefit analysis in favor of bundling of cable networks. It's also that the presence of competition in a marketplace makes it highly unlikely that *mandating* some form of à la carte availability will do anything but make consumers worse off: "This ambiguity as to whether intervention will make things better or worse is reduced as the market for MVPD services becomes more competitive, and would largely vanish for a fully competitive MVPD market."[42]

In a marketplace where consumers can choose from among at least three vibrant MVPD competitors (and with telephone companies increasingly deploying an additional competitive alternative), "[s]elf interest (the need to retain customers) will compel competitive firms to select the pricing strategy their customers prefer. Interfering with this process by mandating a pricing rule is likely to do more harm than good."[43] If à la carte appears to be a more efficient means of maximizing value to consumers, one or more competitors can be expected to offer services in such a manner.[44]

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[41] *Id.* at 212-13.

[42] Wildman at 18.

[43] *Id.* at 20.

[44] As Professor Wildman notes, the Further Report suggests that some program networks might refuse to allow their programming to be offered on an à la carte basis even if operators wanted to do so. But he suggests that whether such determinations at the wholesale level by program networks are or are not efficient and pro-competitive similarly depends on the circumstances: "[T]he questions that would have to be answered to determine whether bundling is or is not an efficient practice at the wholesale level are no less complex than those we wrestle with in evaluating retail prices. Given that wholesale prices in this industry are considerably less studied than retail prices, any proposal that policy should promote à la carte to address problems with the wholesale pricing of networks is more than a bit premature." Wildman at 22.

The fact that competing MVPDs have not generally done so would suggest that, at least in the current environment, à la carte is *not* the best way to maximize consumer value – even if we did not know exactly why.[45] But the evidence and studies in the record of the FCC's proceeding tell us exactly why: The costs of converting to digital technology, the adverse effect on viewership and advertising revenues, the increased marketing costs, and the resulting upward pressure on subscriber fees would force cable customers to pay more to get fewer channels than they regularly watch today – and many fewer than they currently receive and occasionally view. Moreover, as discussed in the next section, it would reduce the quantity, quality and diversity of the networks available to be purchased.

IV. THE FURTHER REPORT DOES NOT REFUTE THE FIRST REPORT'S CONCLUSION THAT À LA CARTE WILL DIMINISH DIVERSITY OF PROGRAM OFFERINGS

A key finding of the First Report was that an à la carte mandate would be likely to diminish the diversity of programming currently available on cable systems. In that report, the Bureau concluded that "[t]he financial impact of à la carte sales or themed tiers on many program networks, especially smaller networks, likely would lead to the demise of a substantial number of these entities, which will reduce the overall universe of channels."[46] Moreover, "the most likely to feel the brunt of such a mandate would be networks serving small niche interests, such as religious programming, programming aimed at minority interests, arts programming and independently owned networks."[47]

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[45] The same is true for the three alternatives to pure à la carte suggested in the Further Report: "Mixed bundling, themed tiers, and subscriber-selected tiers are all more sophisticated mechanisms for price discrimination than is simple bundling. The fact that none of the options has been widely adopted is itself convincing evidence that the costs of implementing these strategies are substantial and likely more than offset the benefits of doing so." *Id.* at 3.

[46] First Report at 118.

[47] *Id.* at 6.

The Further Report does not seriously dispute this finding. To the contrary, the Further Report generally concedes that à la carte is likely, in its words, to "weed out" some currently viable program networks.[48] And it concedes that a likely result is that program networks that appeal to minority and niche interests will disappear and be replaced, if at all, by middle-of-the-road programming that is directed at "mainstream" audiences.[49]

But the Bureau now suggests that there are countervailing *benefits* to eliminating some existing programming networks and replacing minority-interest networks with more mainstream programming. According to the Further Report, when cable operators bundle program networks in tiers, they "may prefer to add niche programming that appeals to a small set of subscribers rather than add additional mainstream programming that provides greater total value to consumers. . . . In contrast, under à la carte, the example shows that the most valued programming is provided."[50]

Thus, the Further Report criticizes the First Report for

> fail[ing] to note that bundling may result in the production of programming for which the consumer value is less than the cost of production, leading to an inflated supply of programming. *If a switch to à la carte eliminated such programming, the result would not be a blow to program diversity, as the First Report suggests, but rather a restoration of programming to an efficient level, more consistent with consumer value*.[51]

The Further Report is simply wrong to claim that this "would not be a blow to program diversity." How could the replacement of niche and minority-interest programming with more "mainstream" programming *not* be a blow to diversity? Maximizing aggregate "consumer

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[48] Further Report, ¶ 49.

[49] *See, e.g., id.*, ¶ 70.

[50] *Id.*

[51] *Id.*, ¶ 73.

value" is not the same thing as maximizing diversity. While it's not at all clear that eliminating niche and minority-interest channels and adding more "least common denominator" programming would, in fact, enhance aggregate consumer welfare, it certainly *would* adversely affect the important public policy interest of diverse expression. Hundreds of commenting parties in the Commission's proceeding and of policymakers, deemed the effect on diversity to be enormously relevant and important.

CONCLUSION

The Further Report purports to examine the costs and benefits of à la carte more rigorously than the First Report. In fact, it is less rigorous and more error-ridden. The Further Report points out that, in theory, à la carte *could* be beneficial for consumers. It suggests that, in theory, advertising revenues *might* not decline and marketing costs *may* not increase so significantly as to have an adverse impact on subscriber fees and on the quantity, quality and diversity of cable network programming. But unlike the Further Report, the First Report based its conclusions not simply on what *could* occur but on an extensive record that showed what most likely *would* occur.

The computational "mistakes" that the Further Report spotlights turn out, when properly corrected, not to alter significantly the findings of the First Report. The "problematic assumptions" of the First Report are, as shown by Professor Wildman, more grounded in the facts and circumstances of the video marketplace – and in the record – than the conjectures of the Further Report.

The First Report showed that requiring cable operators to make programming available à la carte would force most consumers to pay more in order to receive and watch less cable programming and would cause many networks (especially niche and minority-interest networks) to fail. The Further Report's analysis does not, in fact, undermine – and therefore should not obscure – these important findings.

Respectfully submitted,

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Attachment A

A Case for A La Carte and "Increased Choice"?
An Economic Assessment of the FCC's Further Report

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March 9, 2006

A Case for A La Carte and "Increased Choice"?
An Economic Assessment of the FCC's Further Report

I. Introduction and Summary

On February 9, 2006 the FCC released its *Further Report on the Packaging and Sale of Video Programming Services to the Public*[1] (Further Report). In the Further Report, the FCC repudiates the analysis and conclusions reported in its 2004 *Report on the Packaging and Sale of Video Programming Services to the Public*[2] (First Report), which concluded that "a la carte regulation will likely increase operational expenses for MVPDs," that it will "have a significant negative effect on a program network's advertising revenues," and that "it is unclear that an a la carte regime would produce the desired result of lower MVPD prices for many pay-television households."[3] Instead, the Further Report concludes that a la carte has considerable promise and that policies based on a la carte or other departures from current MVPD pricing and network packaging practices merit further study.

It is rare to see an expert agency completely reverse its own study-based findings over a period of less than 15 months, and it is even rarer to see an agency publicly go to such lengths as the Further Report to discredit the work that supported its own recently articulated position. But this is not a simple "after further study and reflection we changed our mind" type of announcement. In attacking the analysis and conclusions of the First Report, the Further Report misinterprets and misrepresents various statements and claims of the First Report and the supporting documents on which it relied. Finally, while the Further Report criticizes the First Report for relying on industry studies submitted in response to the *Notice on A La Carte and Themed Tier Programming*[4] (hereafter Notice) to support its analysis and conclusions, it introduces no additional evidence from outside parties to support its own arguments—choosing instead to reinterpret and reanalyze selected elements of the record on which the First Report had relied.

The goal of this report is to parse the rhetoric to assess the merits of the six principal analytical claims of the Further Report.

- That the First Report's analysis of the price implications of a shift to a la carte is fatally flawed by its reliance on an analytical framework and evidence presented in a study submitted in response to the Notice by Booz

[1] Federal Communications Commission, Media Bureau, *Further Report on the Packaging and Sale of Video Programming Services to the Public,* rel. February 9, 2006 ("Further Report").

[2] Federal Communications Commission, Media Bureau, *Report on the Packaging and Sale of Video Programming Services to the Public,* rel. Nov. 18, 2004 ("First Report").

[3] *First Report,* p. 6.

[4] Public Notice, Comment Requested on a la carte and Themed Tier Programming and Pricing Options for Programming Distribution on Cable Television and Direct Broadcast Satellite Systems, 19 FCC Rcd 9291 (MB May 25, 2004).

Allen Hamilton[5] (BAH) that further analysis has shown to rely on questionable assumptions and contain computational errors.

- That a shift to a la carte would not harm, and might even improve, cable network advertising revenues.
- That the additional marketing costs necessitated by a shift to a la carte are not so large as suggested by the First Report.
- That bundling limits the ability of MVPDs to ascertain demand.
- That bundling distorts incentives to carry networks.
- That mixed bundling, themed tiers, and subscriber-selected tiers—the "additional options for introducing consumer choice"[6] suggested in the Further Report—represent attractive alternatives to the standard bundling arrangements currently employed by MVPDs.

Based on a careful study of the arguments and evidence presented by the Further Report, a review of the First Report and critical evidence and analysis supplied by third parties on which it relied, and my own independent analysis and review of additional relevant literature, I have reached the following conclusions:

- The Further Report's critique of the First Report's pricing analysis is based on two critical errors.
  - A BAH projection that viewing would decline by 23% for certain basic cable networks is misread to apply to all television viewing.
  - Reporting the effects of a partial correction to a calculation error in the BAH report that undercut the BAH pricing conclusion while failing to acknowledge the full correction identified by BAH which left its original conclusions basically unaltered.
- The Further Report's optimistic perspective on the impact of a la carte on cable network advertising revenues neglects critical realities of contemporary media buying.
- The Further Report selectively ignores evidence and studies on marketing networks reported in the First Report that do not support a case against bundling and its reinterpretation of certain marketing studies cited in the First Report is questionable at best.
- The Further Report (as well as the First Report) ignores the ways bundling helps reduce to manageable proportions the information requirements of

5 Booz Allen Hamilton, *The a la Carte Paradox: Higher Consumer Costs and Reduced Programming Diversity: An Economic Analysis of the Implications of a la Carte Pricing on Cable Customers* (July, 2004) ("Booz Allen Hamilton Study").

6 *Further Report*, p. 36.

setting prices and assessing demands for the dozens to hundreds of networks carried by MVPDs.

- The Further Report's argument that bundling distorts incentives to carry networks has no more (or less) force than the argument that a la carte distorts incentives to carry networks.
- The Further report extols the virtues of mixed bundling, themed tiers and subscriber-selected tiers, but does not subject them to rigorous economic analysis. My analysis of these proposals concludes:
  - There is no guarantee that any of these pricing and packaging options will produce either a more efficient selection of networks or greater consumer surplus than simple bundling.
  - Consumer surplus could easily fall with each of these options.
  - For consumers to benefit from mixed bundling, government will have to control prices for hundreds of cable networks. However, price controls could easily make everyone worse off.
- The Further Report's principal contribution to the debate over the pricing and packaging of MVPD services is a convincing demonstration that bundling theory alone does not provide a sufficient basis for constructing MVPD pricing policies.

While bundling theory by itself can not provide adequate guidance for a policy maker to identify the pricing and packaging strategy that best serves the public interest, it can be employed to better discern the policy implications of such factual evidence as is available. My analysis of the economics of the Further Report's three proposals for increasing consumer choice and additional analysis of competition in MVPD services proved particularly instructive in this regard. On the basis of this analysis, I draw the following additional conclusions.

- In competitive markets, MVPDs have strong incentives to employ the pricing strategies that best serve the interests of consumers.
- Mixed bundling, themed tiers, and subscriber-selected tiers are all more sophisticated mechanisms for price discrimination than is simple bundling. The fact that none of these options has been widely adopted is itself convincing evidence that the costs of implementing these strategies are substantial and likely more than offset the benefits of doing so.
- The fact that the DBS services did not employ a la carte pricing or any of the three alternatives proposed in the Further Report when they were new entrants to the market for MVPD services is also evidence that the touted benefits of these alternatives to simpler bundling schemes fall short of the costs they would impose on service providers and customers.

My overall assessment of the Further Report is that it artfully exploits ambiguities in welfare comparisons that are inherent to economic models of bundling and price discrimination to make it appear as if there is a strong case to be made for alternatives to current MVPD pricing practices. A careful reading of the analysis presented in the Further Report shows that this case has not been made. This is particularly striking for the three new pricing policies that the Further Report touts so highly. I am now much more skeptical of their potential to contribute to greater efficiencies in the market for multichannel video services than when I started the background work for this report. In fact, I believe in each case the downside risks outweigh considerably their rather slim prospects for making a positive contribution.

The remainder of this report is organized as follows. The next section presents my analysis of the Further Report's assessment of the First Report's prediction regarding the potential price consequences of a shift to a la carte. Section III assesses the Further Report's claims regarding the likely impact of a la carte on cable networks' advertising revenues. Section IV evaluates the Further Report's claim that the marketing cost increases attendant on a shift to a la carte would not be so large as might be inferred from the First Report's analysis of this issue. Economic models and examples of the type developed in the Further Report are examined in Section V to show that fairly trivial changes are typically sufficient to reverse the conclusions of any example that finds a la carte to be preferable to bundling and vice versa; that, contrary to the strong presumption of the Further Report, there are circumstances in which a MVPD subscriber may benefit from a lower price following the addition of a channel she does not watch; and that competitive MVPDs have strong incentives to select the pricing and packaging strategies that best promote the interests of consumers. Section VI presents a more thorough analysis of the economic properties of mixed bundling, themed tiers, and subscriber-selected tiers than was provided in the Further Report and Section VII draws on the analyses of Sections V and VI to assess the wisdom of using policy to force departures from the pricing strategies MVPDs would choose on their own in an increasingly competitive MVPD market and to draw inferences from the pricing strategies MVPDs have historically elected to employ about the costs to consumers and to MVPDs of forcing a switch to alternative pricing models. Section VIII provides a final assessment of the Further Report.

II. Assessing the Price Consequences of A La Carte

The Further Report does not report independent findings of its own in addressing the pricing consequences of a shift to a la carte. Rather its analysis is focused on the predictions and prediction methodology reported in the First Report. Understanding the Further Report's critique of the First Report's price prediction and where it went wrong requires a brief explanation as to how the First Report arrived at its conclusions.

The First Report's Pricing Analysis

The First Report's analysis of the likely effects of a shift to a la carte on the prices MVPD customers likely would pay for access to networks was multifaceted. In addition to reporting the results of applications of a methodology for predicting the price effects of a la carte presented in the report by Booz Allen and Hamilton (BAH), the First Report also considered the histories of U.S. cable networks that had once been offered as either standalone channels or as components of small elective tiers before securing placement in MVPDs' basic tiers, and reported on the experiences of networks sold a la carte or as components of themed tiers in other countries, most notably Canada. While the Further Report focused largely on the First Report's application of the BAH methodology, it is important to recognize that these network histories provided anecdotal evidence consistent with the predictions based on the BAH model.

Price predictions generated by the BAH model are built up through several stages. MVPDs are assumed to adjust prices for their services in response to changes in the costs of network acquisition and changes in the technical and administrative costs of delivering their services to their customers, so the likely effects of a la carte on these cost elements must be considered to predict its effect on retail prices. Because it is not feasible with analog service to offer large numbers of networks on an a la carte basis, the costs of installing digital set top boxes for the majority of cable subscribers who currently receive only analog service would have to be factored into the calculations if all subscribers were to be offered the option of purchasing their networks a la carte.

The costs to MVPDs of acquiring networks are dominated by the licensing fees they pay to network suppliers. The BAH methodology assumes that the prices network suppliers charge MVPDs for networks reflect their programming costs and the revenues suppliers realize from selling advertising time in their programs. The BAH model employs predictions of the effect of a shift to a la carte on the audiences for different types of networks and network suppliers' marketing costs to calculate how much networks would have to charge MVPDs following a shift to a la carte to meet a pre-specified cash flow margin. BAH predicted increased marketing costs and significant audience losses with commensurate reductions in advertising revenues for most types of basic cable networks and concluded that network license fees would have to increase by substantial amounts if network suppliers were to be able to realize certain cash flow margins.[7]

Retail price predictions were generated by calculating how MVPDs would have to price their services to preserve their cash flow margins given the predicted increases in network acquisition costs. The BAH report calculated that consumers who purchase more than 9 networks would likely face an increase in their cable bills, which is less than the average number of networks regularly viewed today by the typical cable consumer (the typical cable consumer regularly watches an average of 11 cable networks under the current bundled pricing model).[8] The BAH report explored a set of scenarios that produced increases in an average subscriber's cable bill ranging from 14% to 30% under a la carte,[9] a range also reported as a finding by the First Report as applying to a typical

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[7] The authors of the First Report employed this methodology to generate predictions of network license fees for alternative assumptions of network cash flow margins, but the principal predictions offered by BAH and the First Report assume post and pre-a la carte cash flow margins would be the same. *First Report,* p. 91.

[8] *Booz Allen Hamilton Study,* pp. 6-7; see also Appendix 8.

[9] *Booz Allen Hamilton Study,* pp. 32-33.

household purchasing access to the same channels under a la carte that it regularly watches under current arrangements.[10]

While the Further Report criticizes each component of the BAH methodology, its criticism of the pricing analysis presented in the First Report focuses primarily on what it terms an untenable assumption regarding the effect of a la carte on aggregate levels of television viewing and a computation error committed by BAH. I show below that the first of these criticisms reflects a rather puzzling misreading of critical passages in the BAH study and the second is undermined by the Further Report's failure to acknowledge the implications of the correction for a second computation error identified by BAH that largely offsets the effects of the first.

The First Computational Error

In addition to calculating that consumers who purchase more than 9 networks would likely face an increase in their cable bills under a la carte, the BAH report explored a set of scenarios and found that if a household continued to purchase access to the current average of 11 regularly watched networks at a la carte prices, its payments to its MVPD would increase 14% to 30%,[11] a range also reported as a finding by the First Report.[12] Further analysis of the BAH study at the FCC revealed, however, that BAH had failed to remove anticipated charges for the basic tier of broadcast stations from the calculation of the "breakeven" number of cable channels that a customer could buy without seeing an increase in her cable bill. BAH vice president John Frelinghuysen acknowledged this error in a December 16, 2005 letter to FCC Chief Economist Leslie Marx,[13] a fact noted in the Further Report and in a press release by the Commission.[14] [15] According to the Further Report, after correcting for this error the BAH methodology suggests that MVPD subscribers should be able to purchase from 10 to 14 cable networks under a la carte without seeing an increase in their bills.[16] Furthermore, a subscriber purchasing access to 11 networks would see a reduction in her bill in three of the four scenarios examined by BAH.[17]

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10 *First Report,* p. 6.

11 *Booz Allen Hamilton Study,* pp. 32-33.

12 *First Report,* p. 6.

13 *Booz Allen Hamilton Letter,* p. 1.

14 FCC News, *FCC Media Bureau Report Finds Substantial Consumer Benefits in A La Carte Model of Delivering Video Programming*, February 9, 2006. This press release was also attached at the end of the Further Report.

15 FCC Chairman Kevin Martin also made this point in his remarks at the "Open Forum on Decency" conducted by the Senate Committee on Commerce, Science and Transportation on November 29, 2005. Available: http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-262484A1.pdf.

16 *Further Report,* p. 10.

17 *Further Report*, p. 9.

The Further Report's Critical Omission

In the same letter acknowledging the error identified by the FCC, BAH's Frelinghuysen states that BAH also failed to exclude revenues from premium, pay-per-view and video on demand in calculating how many a la carte networks the average consumer could purchase before facing a higher monthly cable bill. Under the revised calculations presented in this letter (reflecting the adjustments for both broadcast channels and for PPV and VOD services), the results do not differ significantly from those presented in the BAH report. The estimated range for the number of networks that digital customers could purchase without increasing their payments increases to 8 to 10 from 7 to 9, and the corresponding change for analog customers is from the 6 to 7 range to the 6 to 8 range.[18] These modest changes alter very little the BAH study's conclusion that consumers would be able to purchase fewer cable networks without increasing their bills under a la carte than they currently watch on a regular basis. While citing BAH's acknowledgement of the error the Commission found, the Further Report fails to mention the second, and the fact that BAH's correction of both leaves their report's conclusions fundamentally unchanged.

The Further Report's Misreading of the BAH Viewer Loss Calculations

The Further Report's critique of the First Report's price analysis is further undermined by a misinterpretation of BAH conclusions as to how basic networks' audiences would be affected by a shift to a la carte. This misinterpretation involves the Further Report's assertion that the BAH report concludes that mandatory a la carte would cause households to reduce their television viewing by approximately 23%.[19] The Further Report thus concludes that "the Booz Allen Hamilton Study and the First Report assume that the average household would watch 2.07 fewer hours of television per day and 14.49 fewer hours of television per week if he (sic) were able to choose the channels he (sic) wanted to watch,"[20] and counters that "[n]ot only is there no support for such an assumption, but it seems unlikely that the average consumer would spend 2 hours more reading, listening to music, or working per day instead of watching television merely because he is no longer required to buy a particular channel of programming."[21]

The BAH report contains no such statements regarding an overall decline in television viewing. Rather, the report states that if consumers only purchased the basic cable networks that they watch most regularly, and no longer had access to all the networks that they now watch occasionally, viewership of *basic cable networks* would decline by about 23%. This interpretation is clear in Figure 15 of the BAH report, which reaches its weighted average of a 23% decline in viewing after accounting for projected viewing declines in six categories of basic cable networks ("Emerging Mass," "Emerging Niche,"

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[18] *Booz Allen Hamilton Letter,* pp. 2-3.

[19] *Further Report*, p. 11.

[20] *Further Report*, p. 11.

[21] *Further Report*, p. 11.

"Older-Skewing," "Younger-Skewing," "News," and "General Entertainment & Sports"),[22] as well as in the text of the BAH report.[23] The Further Report's attribution of the BAH prediction to television viewing as a whole, rather than just the basic networks that were the focus of this component of the BAH study, means that the Further Report's analysis is simply not responsive to this element of the BAH price analysis, or to the corresponding analysis in the First Report.

The BAH report does not assert that total television viewing would decline by 23%; rather, it predicts that a significant proportion of viewing would migrate away from basic cable networks.

Economic Analysis of the Price Effects of Audience Diversion Generates Predictions Qualitatively Similar to those of BAH

The BAH methodology is not the same as what an economist might be expected to employ, as is noted by the Further Report.[24] However the preferred approach described by the Further Report of postulating a price and then estimating demand at that price would require information about demand not available to BAH or to the authors of the Further Report. In fact, one of the Further Report's criticisms of bundling is that it makes it difficult to estimate demand for the individual networks in a bundle. Thus according to the Further Report's own argument, data necessary to employ its recommended approach is not available.[25] In the absence of the type of data required for a pricing study of the type favored by the Further Report, scenario building exercises of the type presented by BAH play a useful role. Nevertheless, it is still helpful to know that the results of a more traditional economic analysis of the price effects of the types of audience diversion predicted by BAH are qualitatively consistent with the BAH analysis.

The license fee a MVPD pays a network reflects the outcome of bargaining over the distribution of the sum of the increase in subscriber payments and advertising revenues attributable to the MVPD's carriage of that network. The greater the increase in advertising revenues the network realizes from carriage by that MVPD, the more it is willing to reduce its license fee to secure carriage.[26] Therefore, if a la carte results in smaller audiences and reduced advertising revenues, license fees should increase. MVPDs can be expected to respond to increased license fees by raising subscription fees.

In addition, cable system operators generate revenue from the sale of ad time reserved for them in cable programs. Cable system operators thus have an incentive to lower

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22 *Booz Allen Hamilton Study,* p. 26.

23 E.g., "we have therefore segmented *cable* networks in order to better model the impact on their economics and the likely response to different a la carte scenarios." *Booz Allen Hamilton Study*, p. 19, emphasis added.

24 *Further Report*, p. 9.

25 *Further Report*, p. 35.

26 This is the wholesale pricing analog to the standard analysis of the relationship between retail prices and ad revenues for media products. See, e.g., V. Chaudri (1998). Pricing and efficiency of a circulation industry. *Information Economics and Policy*, (10(1), 59-76.

subscription fees to increase the size of the audiences they can sell to advertisers. To the extent that audience lost by basic channels under a la carte pricing shifts to over-the-air broadcast channels or to premium channels that have no advertising, cable operators can be expected to respond by raising retail prices—an effect that is independent of their response to increased license fees**.**

III. Further Analysis of the Effect of A La Carte on Basic Networks' Advertising Revenues

As was observed at the end of the previous section, advertising revenues for basic cable networks will decline if they lose audience following a shift to a la carte. Because the BAH viewer loss prediction applied only to certain basic cable networks, one can accept the Further Report's premise that "There is little reason to believe that, given enhanced choice, consumers would watch video programming less than they do today, although they may make some changes in what they watch,"[27] without accepting its follow on conclusion that "[i]n the absence of a change in audience levels, significant decreases in the advertising revenues of program networks are less likely."[28]

The Questionable Value of A La Carte Subscriber Counts to Advertisers

The Further Report also argues that advertisers would find a la carte subscriber numbers to be a better indicator of likely audience size for the hundreds of "unmeasured" cable networks for which advertising buys are based upon the national audience reach they achieve through inclusion in MVPDs' programming bundles. As is discussed in greater detail below, most cable networks do not attract sufficient viewers to meet Nielsen Media Research's minimum thresholds of statistical reliability for reporting network ratings. Thus, these networks are forced to sell their advertising time primarily on the basis of their potential reach (as measured by their household penetration).[29] According to the Further Report, for these "unmeasured" networks, "Subscribership to a channel under a la carte . . . would provide a much more reliable indicator of viewership than inclusion in a broad bundle. People who have chosen to pay for a particular channel are much more likely to watch it."[30]

While this observation is likely true, it refers to viewership predictions for an audience that would be drawn from a likely much smaller pool of potential viewers than would be available to these networks if they secured placement on MVPD's current basic tiers. Whether advertisers would gladly accept the tradeoff of access to a large pool of potential viewers for greater certainty (though still very low for unrated networks) regarding the number of viewers drawn from a likely much smaller pool of a la carte subscribers is a matter of pure conjecture, and, as such, stands in contrast to the conclusions of the First

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[27] *Further Report*, p. 23

[28] *Further Report,* p. 23.

[29] *First Report,* p. 43.

[30] *Further Report,* p. 25, fn. 67.

Report (and the BAH study upon which they were largely based) that were drawn from interviews with professionals in the advertising community and from the testimony of an expert in media advertising who took part in the Commission's a la carte forum.[31]

The Overlooked Importance of Churn

The Further Report's assumption that audience estimates derived from a la carte subscriber figures would be preferred by advertisers also neglects the importance of stability and predictability in audience estimates to the effective functioning of the audience marketplace, where audience purchases often are conducted many months in advance of the airing of the advertisement.[32] Compared to networks in MVPDs' current basic tiers, a la carte networks experience significant subscriber "churn," with the loss of existing subscribers each month, coupled with the attraction of new and returning subscribers, contributing to substantial volatility in the potential audience reach for individual a la carte networks.[33]

Citing industry comments to the same effect, the First Report quite plausibly argued that "[t]he inability to predict distribution levels over time would adversely affect a program network's ability to sell advertising. Reliable estimates of distribution and network ratings months into the future are critical to the sale of advertising."[34] This point holds true not only in terms of general audience size estimates, but also in terms of the demographic composition of these audiences (which also, presumably, could fluctuate significantly over time in an a la carte scenario). For this reason, the "churn" characteristic of the a la carte scenario may be something that commercial-free, subscriber-supported premium networks (such as HBO, Showtime, etc.) may be better able to absorb than networks that depend heavily on advertising support.

Information from a number of sources cited by the First Report also suggests that anticipated lower overall subscriber numbers for networks offered on an a la carte basis may bring those networks below common audience reach thresholds that are utilized within the advertising industry to guide media buys. This, in turn, impacts their ability to attract advertising dollars.[35] As was explained by media buyer Joe Mandel in his testimony at the FCC's a la carte forum, Nielsen does not report ratings for most cable networks with household penetration below 50% because their audiences are too small to

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[31] See testimony of Jon Mandel, Co-CEO of Mediacom Worldwide, *A la Carte and Bundled Channel Offerings in the Subscription TV Industry,* Federal Communications Commission Symposium. Available: http://www.fcc.gov/realaudio/tr072904.pdf ("Symposium Transcript"), pp. 57-58.

[32] *See* Philip M. Napoli (2003). *Audience Economics: Media Institutions and the Audience Marketplace.* New York: Columbia University Press.

[33] Premium networks "turn over more than half of their subscriber rates each year due to high monthly attrition in subscriber levels." *Booz Allen Hamilton Study* at 12.

[34] *First Report,* p. 44.

[35] *First Report,* p. 46.

satisfy Nielsen's criteria for statistical reliability.[36] Potential declines in the quality of information of this type – and their impact on ad spending – must be weighed against any potential gains in information quality that might arise from a switch to a la carte.

To the extent that the identification of these issues in the First Report came from expert testimony[37] and from data derived from interviews with industry professionals[38] it would seem, at minimum, problematic to ignore these considerations in the assessment of the pros and cons of a la carte.

IV. Assessing A La Carte's Impact on Marketing Costs

The First Report and the Further Report differ substantially in their assessments of the likely impact of an a la carte regime on the marketing costs of individual cable networks. The First Report concluded that marketing costs likely would increase markedly under a la carte.[39] The Further Report disagrees, arguing that the First Report overstates the impact of a la carte and that it "provides inadequate analysis of industry allegations that marketing costs would increase dramatically in an a la carte regime. It fails to consider adequately industry assertions regarding the size of these added costs and whether networks could find alternative means to market themselves in a pure a la carte or mixed bundling world."[40] The Further Report, however, bases its conclusions on questionable interpretations (and what appear to be selective omissions) of data and studies relied on by the authors of the First Report, as well as problematic assumptions about the dynamics of contemporary cable marketing.

Questionable Interpretations

A key reason for the divergent conclusions of the First Report and the Further Report on the marketing implications of a la carte is their very different interpretations of the findings reported in studies of the importance of channel surfing to the marketing of individual networks that were submitted to the FCC in response to the Notice. The Further Report takes issue with the First Report's claim that channel surfing is an important, inexpensive mechanism by which consumers learn about new networks that helps to reduce the costs of marketing new networks directly to consumers.

In support of its position, the Further Report notes that a study cited in the First Report "found that less than half of viewers find new channels through channel surfing,"[41] as if anything less than half is less than consequential. However, assuming it to be accurate,

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36 See testimony of Jon Mandel, *Symposium Transcript,* pp. 57-58.

37 *Symposium Transcript,* pp. 57-58.

38 *Booz Allen Hamilton Study,* p. 27, 40.

39 *First Report,* p. 6.

40 *Further Report,* p. 26.

41 *Further Report,* p. 26.

the 45% figure cited in the First Report almost certainly understates the importance of channel surfing as a mechanism by which viewers discover new networks because it does not account for the role of word-of-mouth transmission of the new network discoveries by those who do surf to viewers who don't. It takes only one channel surfer in a household to pass on the benefits of surfing to members of the household less inclined to flip through channels. Similarly, a viewer who channel surfs is likely to inform friends who don't surf of networks she has found and enjoys.

But even if channel surfers did not communicate their discoveries to others, to claim without supporting evidence that the need to find other ways of presenting themselves to the 45% percent of their viewers who discover them by pressing a button on their remote would not be a matter of consequence to networks is simply not credible on its face. Trialability is one of the most significant factors in the consumer adoption process,[42] and as such is more likely to produce regular viewers for a network than is a media campaign. This important difference between marketing messages and product sampling should not be discounted or neglected in comparing the marketing scenarios facing cable programmers in an a la carte versus a bundled environment.

Selective Omissions

This trivialization of the 45% figure in the Further Report is even more difficult to accept in the context of the Further Report's failure to acknowledge the First Report's discussion (in the same section) of other studies reporting that "63 percent of analog tier subscribers and 65 percent of digital tier subscribers use channel surfing as the most used source to find out what is on television,"[43] as well as references to an additional study commissioned by the Cable and Telecommunications Association for Marketing which found that "viewers who start watching a new channel are *most likely* to find it by 'just flipping through the channels.'"[44]

The Further Report argues that, in their efforts to attract viewers from among the pool of potential viewers who purchase MVPDs' basic packages, "networks already are confronting the problem of marketing themselves to non-surfers, even with bundling,"[45] so a transition to an a la carte regime may not significantly impact the challenge that these networks already face in attracting viewers. Even if we ignore the problematic assumption that information viewers acquire from other sources is as credible and as complete as what they can learn by actually watching a network, this argument overlooks a fundamental difference in a network's marketing task in a bundled versus an a la carte environment.

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[42] Everett Rogers (2003). *Diffusion of Innovations* (5th ed.). New York: Free Press.

[43] *First Report,* p. 15, fn. 42.

[44] *First Report,* p. 15, fn. 44, emphasis added.

[45] *Further Report,* p. 26.

A network's marketing task with a la carte is not to persuade viewers to watch programming that is already available to them; rather it is to persuade them to purchase the network in order to view it. Convincing viewers to buy in order to watch is likely to be a much more difficult and expensive proposition than convincing them to briefly tune in to an untried network that is already available. This difference may explain why premium channels (which are offered on an a la carte basis today) spend 15-25% of net sales revenues on marketing, while bundled networks spend only 2-6% of net sales revenues on marketing.[46]

Problematic Assumptions

Other aspects of the Further Report's analysis of the marketing costs issue are similarly problematic. For instance, the Further Report asserts that "some larger, established networks might be able to rely on existing brand name and thus avoid increased marketing costs."[47] Such a perspective represents a dangerously simplistic approach to the dynamics of contemporary marketing, where even brands as established as McDonald's continue to market themselves aggressively in order to keep pace with their competitors. Relying on existing brand awareness while the competition is working to build and expand brand awareness is a strategy that most contemporary marketers likely would consider woefully inadequate, and perhaps even a recipe for disaster.

Even large, established cable networks often go through rebranding exercises that are associated with changes in programming strategies.[48] As those nostalgic for the days when MTV and VH1 actually used to play music videos can attest, even successful, established networks can dramatically change their programming strategies; in which case simply relying on an existing brand identity is likely to be inadequate from a marketing standpoint. To the extent, then, that an a la carte model may force established networks to rely upon their established brand identities, it seems possible that substantial disincentives to innovate with programming may be created.

The Neglected Information Advantages of Bundling

In assessing the impact of a move to an a la carte model on the marketing costs faced by MVPDs, it is also important to consider the comparative costs of gauging consumer demand for bundles of networks and for the same networks sold individually at a la carte prices. A theme repeated in the Further Report is that under an a la carte system cable operators and networks would acquire much more complete information on the demand for individual networks than with bundling because "[e]ven when the MVPD wants to carry the most-desired networks, it may have difficulty determining which ones are most popular with viewers under bundling. Whether or not a network gets carried depends on

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46 *Booz Allen Hamilton Study,* p. 28.

47 *Further Report,* p. 11.

48 Consider, for instance, the TNT network's recent "We Know Drama" branding campaign, which reflected the popular and established network's increased emphasis on dramatic programming, while at the same time the sister TBS network was rebranded to reflect its emphasis on comedy programming.

an MVPD's guess as to the popularity and profitability of carrying a network. Since consumers are buying a bundle of networks, and since Nielsen does not rate smaller networks, the MVPD may have little information about how much consumers value the ability to watch a particular network, even after carrying it for a while."[49]

This argument for the informational advantages of a la carte over bundling comes up short in a number of respects. First, because it is the lightly-viewed networks that do not have Nielsen ratings, no cable operator should ever "have difficulty determining which ones are most popular."[50] The most popular networks are those for which ratings data *are* available. Second, the need to account for substitutability relationships and complementarities among networks makes it difficult, if not impossible, to accurately assess the value of individual networks on a standalone basis. In the case of complements, there likely will exist no efficient standalone prices.[51]

Third, the Further Report's argument ignores the incentive bundling gives MVPDs to identify the demands of viewers not willing to pay a la carte prices for networks who would still benefit from having them available, because such demands may be reflected in the price of a bundle of networks. Fourth, and perhaps most fundamental, this argument in the Further Report fails to consider the information-processing capacity of the relevant decision-makers. The scenario outlined in the Further Report is one in which MVPDs are required to acquire and process relatively complete information on the demand for dozens to hundreds of individual networks. This represents a substantial information processing burden and expense, something the Further Report does not consider.

From an information processing standpoint, bundling in fact represents an efficient way to economize on the information processing requirements associated with assessing consumer demand in such a complex business as multichannel video services. It is much easier, and less costly, to estimate demand for a bundle of networks than for each network individually, especially when the demands for individual networks are not independent of each other as noted above. The fact that many contemporary cable

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[49] *Further Report,* p. 35.

[50] *Further Report,* p. 35.

[51] Networks that are complements raise particularly difficult pricing problems in an a la carte environment. Because each of two complementary networks increases the value of the other, the sum of their marginal values exceeds their combined value to subscribers. Therefore, a MVPD cannot set independent prices for the two networks that both equal their marginal values and do not sum to more than their combined value. Complementarities may arise in a number of ways. For example, a movie fan may enjoy a movie channel more because she can learn more about actors starring in movies carried by the channel when they are interviewed on CNN. At the same time, CNN is valued more because its interviews with celebrities increase its demand among movie fans. Complementarities may also arise when two or more networks can benefit from cross-promotions and collaborative programming strategies (e.g., repurposing of the same program across networks, "handing off" of viewers from one network to another for continued coverage of an issue or event) leading to the consumption of one network increasing demand for a second network. It should be obvious that demand complementarities among networks should be considered in any policy analysis of bundling in the supply of networks to MVPDs.

systems have the capacity to provide operators with channel-specific (and even household-specific) data on television usage via set top boxes[52] raises further questions about whether simple a la carte subscriber numbers represent a meaningful improvement over existing practices for assessing consumer demand. These capacities appear to be largely unutilized up to this point, which may be a reflection of the magnitude of the information processing costs discussed above.

This information processing issue applies to the consumer side of the equation as well, something that the Further Report does not address. That consumers regularly watch only a relatively small fraction of the networks available to them and this fraction continues to decline as their viewing options increase[53] may reflect the difficulties consumers experience sorting through their options even when they can be sampled for free. In this environment, the sampling behaviors facilitated by bundling are critical to the process by which consumers establish and alter their "channel repertoires."[54] It seems unreasonable to deny that the information processing burdens of consumers would be substantially increased if they were required to establish and alter these channel repertoires by attending to the advertising and marketing campaigns of potentially hundreds of cable networks.

V. The Economics of Bundling vs. A La Carte in Monopoly and Competitive Markets

It is important to recognize that the economic models and examples comparing bundling with a la carte represent highly simplified hypothetical worlds in which only the costs of networks and their values to individual consumers matter. Stripped away are a large number of other relevant considerations, such as marketing and administrative costs, so that the economic analyst can isolate the influence that network costs and consumer demands have on how a MVPD chooses, packages, and prices the networks it offers its subscribers. A complete analysis requires that these other factors be considered as well. Nevertheless, as was noted in the introductory section of this report, there is some merit in the Further Report's claim that the First Report did not address as fully as it might have the fact that economic models of bundling show that there are conditions when bundling by a monopolist may reduce economic efficiency and harm consumers compared to a la carte, as well as conditions where bundling more effectively promotes the interests of consumers and economic efficiency.[55]

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52 Bill Harvey, Tony Jarvis, & Russ Booth (2002). *Better audience measurement through cable and satellite set top boxes.* Paper presented at the annual ESOMAR/ARF Week of Audience Measurement conference. See also Bill Harvey (2003). *Better television audience measurement through the research integration of set-top box data: Phase two.* Paper presented at the annual ESOMAR/ARF Week of Audience Measurement conference.

53 See Napoli, *Audience Economics.*

54 See Douglas Ferguson and Elizabeth Perse (1993). Media and audience influences on channel repertoire. *Journal of Broadcasting & Electronic Media, 37*(1), 31-48.

55 *Further Report,* p. 17.

The Ambiguous Welfare Predictions of Bundling Theory

The Further Report illustrates this point with a series of eight examples of a monopoly MVPD for which consumer surplus is greater if networks are priced a la carte or offered under one of the pricing and packaging schemes proposed by the Further Report rather than sold as a bundle.[56] The first of these examples, which is described below in Table 1, has two consumers, A and B, and two networks, 1 and 2. A would be willing to pay as much as $5 for network 1 and $3 for network 2; B values 1 at $3 and 2 at $5. They are thus both willing to pay $8 for the two networks sold as a bundle.

Suppose the MVPD incurs a cost of $*x* for each network. Then as long as $x<6$, the MVPD would maximize its revenue (and presumably profits[57]) by selling each network at a price of $3 if forced to use a la carte pricing. Because each network is acquired by both consumers, economic efficiency (measured as the sum of consumer and producer surplus) would be the same with a la carte as with bundling and consumers would benefit from lower total payments ($6 vs. $8) under a la carte.

Table 1

		Consumers	
		A	B
Networks	1	5	3
	2	3	5
Value of bundle to each consumer		8	8

Only slight changes to this example are required to produce situations in which bundling is more efficient and situations for which a la carte is both more efficient and provides greater benefits net of payments to consumers. As an illustration of the former possibility, the First Report presented an example that was identical to Table 1 (Example 1 in the Further Report) except that consumers were willing to pay only $2 for their least

[56] These examples are presented in the Economic Appendix to the Further Report beginning on page 48 and are described in general terms for illustrative purposes in the main body of the Further Report beginning on p. 21.

[57] The examples in the Further Report assume a MVPD incurs a fixed cost for acquiring a network that is independent of the number of subscribers who have access to it. I retain that assumption in this report to facilitate comparison with the examples presented in the Further Report even though it might be argued that the nature of contracts with networks are such that MVPD's acquisition costs vary with the number of subscribers given access to a network. However, as long as there is a nontrivial fixed component to network acquisition and delivery costs, which would include the opportunity cost of the channel occupied, the qualitative attributes of the examples should be unaffected as subscribers' valuations of networks can be reinterpreted as willingness-to-pay net of per subscriber network license fees.

preferred networks.[58] In this case, a la carte prices would be $5 per network and each consumer would purchase only one. As consumers pay full value for their most preferred networks and don't purchase their least preferred networks, they are indifferent between a la carte and bundled pricing, but bundling is more efficient because each consumer can watch two networks they value instead of one.

The Further Report modifies its Example 1 by adding a third consumer who values network 1 at $3 and network 2 at $0. This consumer would purchase network 1 at its $3 a la carte price, but the price of the bundle would never be reduced to the $3 required to get C to purchase it. So for this variation on Example 1 (1.b in the Further Report), consumer surplus is greater with a la carte pricing and the fact that an additional consumer would watch network 1 means that a la carte would be more efficient as well.

It is also easy to modify the Further Report's Example 1 to create situations for which bundling is both efficient and delivers greater value to consumers than does a la carte pricing while the price of the bundle falls with the addition of a new network. This is the case for the situation described by Table 2, which has four consumers and three networks. As long as the cost of network 3 is less than $8, the MVPD would prefer to sell a single bundle of three networks for $6, a price that all four consumers would be willing to pay, to selling a bundle with only networks 1 and 2 for $8. The sum of the values of the bundle to all four consumers is $30, $6 more than subscribers' total payments of $24.

Table 2

		Consumers			
		A	B	C	D
Networks	1	5	3	0	1
	2	3	5	2	0
	3	1	0	5	5
Value of bundle to consumers		9	8	7	6

If forced to sell its networks a la carte, the MVPD would price networks 1 and 2 at $3 each and network 3 at $5. Subscriber payments would total $22, but total benefits from viewing would be only $26 as subscriber A would no longer watch network 3, subscriber C would no longer watch network 2, and subscriber D would not pay to watch network 1. So consumer benefits net of subscription fees would fall by $2 if the MVPD switched to a la carte pricing.

This last variation on the original example also demonstrates that a reduced subscription fee cannot be equated to an increase in consumer welfare. Consumer welfare can actually fall due to a forced reduction in payments because the value of the product delivered may decline by a more than commensurate amount. For the same reason,

58 *First Report,* p. 82.

consumer welfare may increase following an increase in price if the value of the product purchased increases by an even greater amount.

A Consumer Does Not Always Pay More, and May Pay Less, When a Network She Doesn't Watch is Added to Her Bundle

The Further Report states that a MVPD will add a network to its bundle only when doing so enables it to raise price or increase the number of subscribers.[59] However, this example shows that a MVPD may also add a network that lowers the price of the bundle if doing so increases sufficiently the number of consumers purchasing the bundle. It does this for the same reason that a firm selling a single product typically finds it most profitable to charge a price that is less than the maximum the market will support—because lowering price increases sales and up to a point this increases profits as well.

This example also shows that a subscriber may benefit from a reduction in the price for service when a network she never watches is added to the bundle to which she subscribes, as is the case for consumer B in Table 2 when network 3 is added to the bundle that previously contained only networks 1 and 2. The possibility that the price of a bundle of networks may fall as new ones are added even when some viewers purchasing the bundle will never watch them is worth noting because it is not considered in the Further Report or in the First Report.

The main point of these variations on the Further Report's Example 1 is that it requires very little imagination to proliferate examples for which bundling is more efficient and serves consumer interests better than a la carte and examples for which a la carte performs better with respect to both objectives. As a consequence, these rather austere bundling models by themselves can provide no guidance as to whether consumer welfare or efficiency interests would be better served by forcing MVPDs to price their networks a la carte instead of offering the current bundles of networks (with pay channels available on a per channel basis), or whether consumers would be made worse off and efficiency suffer if a shift to a la carte was mandated. The best that can be said is that if we ignore the cost and marketing issues addressed in the previous two sections, neither possibility can be ruled out on the basis of theory alone. This ambiguity as to whether intervention will make things better or worse is reduced as the market for MVPD services becomes more competitive, and would appear to largely vanish for a fully competitive MVPD market.

MVPDs Are Likely to Make the Right Choices in Competitive Markets

The First Report cited an article by Bakos and Brynjolfsson that models competition between two firms, each of which supplies many information goods (which could be cable networks).[60] Bakos and Brynjolfsson find that in a competitive equilibrium bundling serves efficiency and consumer interests better than does a la carte pricing. The

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[59] *Further Report,* p. 18.

[60] Yannis Bakos and Erik Brynjolfsson, *Bundling Information Goods: Pricing, Profits, and Efficiency*. Management Science, 45(2), December 1999, at 1613-1630.

Further Report dismisses the Bakos and Brynjolfsson paper as irrelevant to questions related to the pricing of MVPD services because of certain symmetry assumptions employed in the model and because a consumer buys both bundles in their equilibrium, unlike the common situation for MVPD subscribers who, when choosing among the offerings of the local cable system and its two DBS competitors, typically purchase service from a single MVPD.[61]

The Further Report fails to ask, however, whether the Bakos and Brynjolfsson analysis illustrates a more general principle that would apply to an analysis of pricing options for MVPD services—namely that in competitive markets various price discrimination strategies may actually benefit consumers. There are sound reasons to believe that this is the case, which means that when they are observed in competitive markets consumer interests may be harmed if firms are forced to abandon them.

Competition operates to transfer producer surplus to consumers, and when competition forces profits to zero consumers get it all.[62] The firms who survive in a competitive market should therefore be the ones who do the best job of creating benefits for consumers. If bundling, or efficient price discrimination, makes it possible to increase the total benefits provided by producing and selling a group of products, then we would expect these devices for discriminating among consumers to be employed in competitive markets and, further, that consumers likely will benefit from their application.

These points can be illustrated with slight modifications to the examples we have been working with. Recall that x is the cost to a MVPD of acquiring a network and assume that the set of networks provided by a MVPD and consumer valuations for those networks are as shown in Table 1. If competition forces the price of the bundle of networks 1 and 2 down to a level that just covers the MVPD's costs, consumers A and B will each be charged \$$x$ for the two network bundle and realize consumer surplus of 8-x dollars each as long as there is a single price for the bundle that applies to all subscribers. We are interested in the answers to two questions regarding this situation. (1) Could a competitive MVPD offer the same value to subscribers with a la carte pricing? (2) Could a competitive MVPD employing a la carte prices survive in competition with a MVPD offering the same networks as a bundle?

The answer to the first question depends on the value of x. If $x \leq 6$, a competitive MVPD charging a la carte prices of \$$x/2$ per network would offer the two consumers the same benefits (and society the same efficiencies) as a MVPD selling the two networks as a bundle priced at \$$x$. In both cases the MVPD would just break even and each subscriber would realize benefits net of price of 8-x dollars. On the other hand, if $8<x<6$, competitive MVPDs selling the two networks as a bundle would price the bundle at x and provide each of the two consumers with net benefits of \$(8-x); but there are no a la carte

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[61] *Further Report*, p. 22.

[62] This is not equivalent to saying that economic efficiency is maximized in a zero profit, competitive equilibrium where price-discriminating firms compete by offering differentiated products. The number of competitors in such market may exceed the welfare optimum, as is demonstrated in a recent article by V. Bhaskar and Tred To, *Is Perfect Price Discrimination Really Efficient? An Analysis of Free Entry*. RAND Journal of Economics. 35(4), Fall 2000, at 762-776.

prices that would enable a MFPD to recover its costs. Suppose *x* is \$7. Then mandating a la carte pricing would eliminate a total of \$2 in consumer surplus.

Of course, with the consumer demands of Table 1 and networks costing \$7 each, mandated a la carte would also preclude a monopoly MVPD from supplying these networks. The critical feature is that the smaller consumer valuation is less than $x/2$. The difference is that with competition (and bundling), the \$2 in surplus would be realized by consumers, while in a monopolized MVPD market the MVPD would benefit. Mandating a la carte pricing would still eliminate \$2 in economic surplus, however. When there are hundreds of differentiated networks, as is the case today, it is hard to believe that there are not collections of networks that can only be supplied if sold in bundles. Nevertheless, one might argue that in the monopoly situation it is possible that consumers would still benefit from lower prices on other networks if MVPDs were forced to price them a la carte.

This argument has little force if a market is competitive. This is not because there are no situations in which a la carte delivers more benefits to consumers than bundling in competitive markets. Rather, there is no need to mandate a la carte in a competitive market when firms can employ it to offer consumers a better deal than firms who bundle their products (as is evident from inspection of the competitive market variant of the Further Report's eighth example[63]), just as there is no need to mandate bundling when firms with bundles can serve consumers better than those with a la carte prices. Self interest (the need to retain customers) will compel competitive firms to select the pricing strategy their customers prefer. Interfering with this process by mandating a pricing rule is more likely to do harm than good.

Competition Among MVPDs and Networks Can Solve the Too Costly Network Problem

The sixth of the Further Report's eight examples was introduced to demonstrate that with bundling, a MVPD may have an incentive to add a network that costs more than the benefits it provides consumers because it enables the MVPD to increase revenues from subscribers by more than the cost of the network. This example is another variation on the Further Report's Example 1 in the sense that it assumes the combination of networks and consumer demands as described in Table 1 above. The difference is that in Example 6 network 2 is assumed to cost \$9, a dollar more than the sum of its value to the two consumers. This situation is described in Table 3.

[63] *Further Report*, pp. 60-61.

Table 3

		Consumers		Network
		A	**B**	**Cost**
Networks	1	5	3	5
	2	3	5	9
Cost of bundle				14
Value of bundle to consumers		8	8	

This particular bundle likely would not be sustainable long term in a competitive market. The MVPD would prefer to sell only network 1 at prices that reflect its different values to the two subscribers. A price of just under \$4 for consumer A and the same price minus a discount of \$2 that only consumer B qualifies for would increase both consumers' surplus over what they would realize at the competitive price for the two networks as a bundle and allow the MVPD to make nearly a dollar profit. Of course, competition would eliminate this profit too, resulting in prices that sum to \$5.

Competing suppliers of networks can also be expected to search for pricing and programming strategies that would enable them to supply the MVPD with a network that consumers value at least as much as it costs while allowing the MVPD to construct a bundle with values to A and B that differ less than the \$2 difference in their valuations of network 1. Consider for example a network Z that costs \$4 and is worth \$1 to consumer A and \$3 to consumer B. The MVPD could pay Z's supplier \$4.25 and charge a price of \$4.75 for the bundle and make a profit of 25¢. Each consumer's surplus would also increase by 25¢. The MVPD would clearly prefer Z over network 2 in Table 3; and if Z didn't exist network suppliers would have a strong incentive to try to develop a network with such characteristics. Of course competition would drive the price of Z to \$4 and the price of the bundle of networks 1 and Z to \$4.50, so the networks and the MVPD would break even and consumer surplus would rise to \$1.50 per consumer. Mandated a la carte pricing would increase efficiency and consumer surplus only if competitive firms were not able to devise effective mechanisms, such as those just described for discriminating among their customers.

With Bundling, Networks that Cost More than Their Value to Consumers Can Still Increase Efficiency

It is also important to recognize that even if no network like Z is to be found, there are situations for which the addition of a network like network 2 to a MVPD's bundle can actually increase efficiency, and if there is competition, benefit consumers as well. Suppose the cost of network 1 is more than \$6 and less than \$7, say \$6.50. For this situation there is no a la carte price that can support network 1 if it is sold by itself. However, as a bundle the two networks are worth \$8 to each consumer, which exceeds the \$15.50 cost of the bundle. Consumer benefits can now be realized that could not be captured with a la carte prices because a network worth less to consumers than its cost was bundled with network 1. In a competitive market, each subscriber would pay \$7.75 for a bundle valued at \$8. Viewed by itself network 2 appears to be an inefficient addition to the bundle, but seen as a mechanism for unlocking potential consumer benefits that would otherwise never be realized, bundling it with network 1 is clearly efficiency enhancing—an outcome that could not be realized with a la carte prices.

We Know Too Little to Suggest A La Carte as a Remedy for Wholesale Pricing Problems

The Further Report suggests that MVPDs may benefit from mandated a la carte pricing because they would no longer be forced to accept the demands of powerful network suppliers that they license their networks as bundles,[64] but the questions that would have to be answered to determine whether bundling is or is not an efficient practice at the wholesale level are no less complex than those we wrestle with in evaluating retail prices. Given that wholesale prices in this industry are considerably less studied than retail prices, any proposal that policy should promote a la carte to address problems with the wholesale pricing of networks is more than a bit premature.[65]

VI. The Further Report's Three "Additional Options for Introducing Consumer Choice"

As the previous section made clear, the theory of monopoly bundling does not provide clear guidance as to whether consumer interests and economic efficiency would be better promoted by bundling or a la carte pricing. In its Section III, the Further Report suggests three "additional options for introducing consumer choice." Limited to channels already available in a digital format to minimize implementation costs, these are: (1) mixed bundling, which would make all of a MVPD's digital channels available on an a la carte basis while preserving the option of purchasing whatever bundles the MVPD might want to offer; (2) themed tiers, which would be tiers of networks that address specific interests in content, such as children's programming; and (3) subscriber selected tiers—which would give consumers the option of purchasing smaller bundles of networks of pre-specified size and selecting the networks to go in the bundles. The second two proposals, like the first, would also give MVPDs the opportunity to offer packages of networks of their own construction, including those bundles and a la carte offerings (such as current premium channels) they would have provided if they were not compelled to offer one of these government-mandated options. These pricing schemes are described as offering consumers the benefits of additional choice while permitting MVPDs to continue to realize the efficiency advantages of creating the bundles they want—apparently the best of both worlds.

Surprisingly, the Further Report provides little economic analysis of its own proposals. We have already seen that more choice in the form of a la carte can make consumers worse off as well as better off. I show below that this is also the case for each of the new proposals. Furthermore, it is hard to see how even in the most favorable circumstances these new pricing schemes will improve consumer welfare unless regulators become

[64] *Further Report,* Economic Appendix, p. 49 and n. 5.

[65] See also the discussion of issues raised by complementarities among networks in footnote 51.

directly involved in setting the prices for individual networks and tiers. In analyzing these proposals, I will use the examples described by Tables 1 and 2 in the previous section, which are repeated below as Tables 4 and 5.

Mixed Bundling

The situation described in Table 4 would seem to be favorable to mixed bundling. The previous section showed, following the Further Report, that consumers would benefit from a la carte prices of $3 for each network versus the monopoly price of $8 for the bundle. In addition, the consumer benefits of a la carte would not be purchased at some sacrifice of economic efficiency because both consumers watch both networks with each pricing scheme. Because MVPD profits are higher with bundling, if the MVPD has the right to set prices at their profit maximizing level we would expect it to set the a la carte prices a bit over $5 and continue to sell the bundle at a price of $8. Consumers would choose the bundle and life would go on as before.

Table 4

		Consumers	
		A	B
Networks	1	5	3
	2	3	5
Value of bundle to each consumer		8	8

How should policy makers respond if all (or almost all) consumers take the bundle? One possibility would be to have the FCC set prices for the individual networks and let the MVPD determine the price for whatever bundles it offered. Alternatively, the government could set these prices too. Once faced with the enormity of the task of estimating demands for each of dozens to hundreds of networks (some of which are certain to be interdependent) so that prices can be set appropriately, the Commission might reconsider the wisdom of the suggestion in the Further Report that MVPDs might benefit from a shift to a la carte because "bundling limits ability to ascertain demand."[66]

Suppose instead that MVPDs were required to set prices such that a non-trivial number of consumers took the a la carte option. A la carte prices of $5 per channel and a bundle price of $8 would accomplish this goal. Consumers would pay full value for either the bundle or a single a la carte channel and so would be indifferent between the two options. Half presumably would choose the bundle and half would purchase a single channel. For this two-subscriber example, MVPD revenue would be $13 versus $12 with pure a la carte, so the MVPD would choose this set of prices if required to employ mixed bundling. But now one of the two consumers is watching one channel instead of two, so efficiency (total surplus) has fallen while consumers are no better off.

[66] *Further Report,* p. 35.

It can be shown that a simple adding up rule requiring that the sum of the prices for the two networks be no more than the price charged for the bundle[67] will force the MVPD to lower the price of the bundle to $6 and the a la carte price to $3.[68] As long as the sum of the costs for the two networks was no more than $12, consumers would benefit and efficiency would not suffer from implementation of an adding up rule of this type. Unfortunately, the adding up rule does not always have such salutary effects. If the cost of the two networks is greater than $12 (but still less than their total value to consumers of $16), the adding up rule would force the MVPD to exit the market because there is no sustainable combination of a la carte and bundle prices that will cover its costs.

Now consider the situation described by Table 5. I showed in Section V that consumer benefits are greater if the three networks are sold as a bundle at the profit maximizing bundle price of $6 per subscriber than if the networks are sold a la carte. Note, however, that the MVPD would realize the same revenue and profits with mixed bundling by charging (just under) $9 for the bundle and $5 for each of the networks individually. MVPD revenues would be $24,[69] the same as for selling the three networks as a single bundle, so the MVPD should not care. But now $6 in consumer welfare has vanished, leaving consumers with zero net benefits from the service.

Table 5

		Consumers			
		A	B	C	D
Networks	1	5	3	0	1
	2	3	5	2	0
	3	1	0	5	5
Value of bundle to consumers		9	8	7	6

67 An article by Aron and Wildman proposes such a rule to address a very different situation. They show that if one of the goods in a two-good bundle is supplied by a monopoly seller, the adding up rule will prevent leveraging control over the monopolized good to exclude competitive suppliers of the second good in the bundle. See Debra J. Aron and Steven S. Wildman (1999). Effecting a price squeeze through bundled pricing. In Sharon Eisner Gillett and Ingo Vogelsang (eds.), *Competition, Regulation, and Convergence: Current Trends in Telecommunications Policy Research.* Mahwah, NJ: Lawrence Erlbaum Associates, 1-17.

68 For any bundle price less than $8 and greater than $6, each subscriber realizes greater surplus purchasing her highest valued network at half the bundle price and refusing to buy her least valued network than from purchasing the bundle. The MVPD can thus earn a maximum of $8 from the sale of one network each at $4 to each consumer. At a price of $6 for the bundle and a $3 a la carte price, each subscriber is indifferent between purchasing the bundle and purchasing both networks a la carte. The MVPD's revenue would be $12 in either case. Beyond this point lower prices reduce revenue.

69 A would purchase the bundle, B would purchase network 2 and C and D would purchase network 3.

Conclusion: When subjected to careful economic analysis, mixed bundling loses its appeal. Consumer welfare and economic efficiency may both decline even when per network prices are sustainable. It appears that the government would have to get involved in the messy process of setting prices for dozens to hundreds of digital channels to ensure consumers benefit in the best of circumstances, and even then an attempt to control prices could backfire and make everyone worse off.

Themed Tiers

Table 5 can be used to illustrate the replacement of a single bundle of programs with themed tiers. Suppose that network 1 is a news network, network 2 is a general entertainment network, and network 3 is a sports network. If we think of a themed tier as general interest programming enjoyed by almost everyone packaged with more specialized networks that appeal to a narrower spectrum of tastes, a two network bundle of networks 1 and 2 could be a news-themed tier and the bundle of 2 and 3 a sports-themed tier. If we think of news coverage of sporting events as complementary to broadcasting them on television, the sports-news combination of networks 1 and 3 might be considered a themed tier too. The bundle of all three networks would be a fourth tier, but not a themed tier.

A profit maximizing MVPD selling access to these four tiers would price the unthemed tier of all networks at $9, the news tier at $8, the sports tier at $7, and charge $6 for the sports-news tier. This clearly would be a good deal for the MVPD, as total revenue would increase by $6 over the $24 from the sale of the same networks as a single bundle. Consumers clearly would not like the switch to themed tiers, however, because $6 of consumer surplus they enjoyed under simple bundling would be transferred to the MVPD.

In this example, as in Example 8 in the economic appendix to the Further Report, the MVPD's revenues rose following a switch from simple bundling to themed tiers. The reason is the same for both examples—for the situations described, themed tiers is a more effective mechanism for price discriminating among consumers than is simple bundling. In the Further Report's example, an extra consumer was able to purchase service following the switch to themed tiers, which means total surplus increased as long as there were not offsetting costs associated with the switch. Absent such offsetting costs, in a market with many heterogeneous consumers, a profit-maximizing MVPD should generally prefer themed tiers to simpler bundles.

We must then ask why themed tiers are a relatively rare phenomenon. One possibility is that the marketing costs, administrative costs, and the costs of acquiring the information required to set prices for a larger number of offerings more than offsets any revenue gains realized from a switch to themed tiers. If this is the case, economic efficiency would be reduced by a forced switch to themed tiers once the added costs were taken into account.

Conclusions: If there are no offsetting costs involved in a switch from a single bundle to themed tiers, there is no need to mandate themed tiers because MVPDs will prefer themed tiers over simple bundling for its superiority as a mechanism for price discrimination. In this case, efficiency likely will not fall due to a switch to themed tiers, and it may increase. On the other hand, subscriber benefits (net of price) are not likely to increase and they may fall because in some circumstances themed tiers will enable MVPDs to capture surplus that would have been enjoyed by consumers under simple bundling. If MVPDs prefer not to employ themed tiers due to the added costs of implementing and operating a more complicated pricing mechanism, forcing the switch likely will reduce economic efficiency.

Subscriber-Selected Tiers

Again, consider the situation described by Table 5. With subscriber-selected tiers the MVPD sets a schedule of prices for tiers with varying numbers of networks, the identities of which are to be determined by each subscriber. For this situation and subscriber-selected tiers, a profit-maximizing MVPD will offer a tier of three channels for $9, a two-channel tier for $8, and a single channel for $5 and earn revenue of $27, $3 more than with a single bundle. Subscriber C will no longer watch network 2 and subscriber D will no longer watch network 1, so economic efficiency will decline. Furthermore, subscribers A, B and C will experience a collective loss of $6 in consumer surplus.

As with themed tiers, for this example subscriber-selected tiers is superior to simple bundling as a mechanism for an MVPD to extract surplus from consumers. Absent offsetting costs from managing subscriber-selected tiers, MVPDs would switch to this strategy (or themed tiers) on their own. The fact that subscriber-selected tiers is not offered by MVPDs voluntarily suggests that substantial costs would be incurred in doing so and that total welfare would decline if such a switch were mandated.

Conclusion: As with mixed bundling and themed tiers, there are no compelling theoretical reasons to expect a mandated switch to subscriber-selected tiers to either improve efficiency or increase consumer benefits from MVPD services.

Overall Assessment of the Further Report's Three Options for Improving Consumer Choice

Each of the three pricing options proposed in the Further Report is a more sophisticated scheme for price discrimination than is simple bundling. To the extent their voluntary application increases efficiency in the simple monopoly examples developed here and in the Further Report, it is because they enable firms to extract more surplus from consumers. Unfortunately, there is no guarantee consumers will benefit from any of these schemes, and each could easily result in substantial reductions in consumer surplus. Price controls might transfer more of the potential efficiency benefits of mixed bundling (when they exist) to consumers, but this would put government in the messy business of setting prices for individual networks, and, as illustrated above, attempts to set prices could also reduce dramatically the benefits of MVPD services to all parties.

Firms' profits increase when they can devise ways to more effectively discriminate among their customers, so they don't need encouragement from the government to employ them when they work. The simple fact that profit-motivated MVPDs have not shown themselves eager to implement any of these options should be taken as a strong indicator that the costs of implementing these schemes—the marketing, information and coordination costs whose significance the Further Report downplays—are substantial.

What Have We Learned From the Theory?

There are cases, such as the benefits of policies promoting competition, where theory can provide a fairly secure foundation for policy prescriptions. The analysis in this section and in Section V, which has been largely abstract and theoretical, shows, along with the corresponding analysis in the Further Report, that the pricing of MVPD services is one of those cases where theory provides little guidance as to what to do. None of these theories and models provides a clear cut prediction as to the welfare effects of a forced shift to a new MVPD pricing regime. As all the new analysis in the Further Report suggesting possible benefits from a shift to a la carte or to one of the other three "options for introducing consumer choice" is either theoretical or speculative in character, the Further Report provides no foundation for new policy.

We do know more now about the potential downsides of these policies, however, and can see that these can be quite large. Furthermore, theoretical considerations outlined above suggest that the costs to MVPDs, which are social resource costs as well, of a shift to one of these alternative pricing models may well be substantial.

VII. More on the Costs of Mandating Alternative Pricing Models

Section VI pointed out that the fact that MVPDs have not availed themselves of pricing strategies, which, according to simple economic models of bundling, should increase their profits, suggests that economic considerations not addressed in these models—most likely increased marketing and administrative costs—have prevented their adoption. It may also be the case that MVPDs do not anticipate significant increases in revenues resulting from their adoption, but as these are more effective mechanisms for extracting surplus from consumers, the realization of substantial consumer welfare gains from their implementation is questionable in any case if these proposals are viewed as limiting the exercise of market power. A considerable period of trial and error would almost certainly be required before any of these pricing strategies could be implemented effectively.

From a MVPD's perspective, the consumer demand for its current bundles is the aggregate of the very disparate demands of thousands to millions of individuals. Ratings data tell us how many people watch each of the more popular networks, but not how individual viewers distribute their viewing hours among the options available. And ratings tell us little about how much consumers are willing to pay for networks. Learning more about how to price networks on a standalone basis, or as elements of the two more complex bundling schemes proposed in the Further Report, would almost certainly be an arduous and costly process with little reason for confidence that the end product would be an improvement over what we have now.

This conclusion is reinforced by the history of competition in MVPD services in the United States. New entrants gain share from incumbents by offering consumers more attractive combinations of price and quality. If a la carte or any of the other three approaches to pricing MVPD services proposed in the Further Report had the potential to offer consumers greater benefits than they realize from the bundles of basic services offered by cable companies, we should have seen the two DBS companies employing these pricing strategies when they were new entrants trying to get a toehold in the market. Instead, they entered with bundles of networks similar to those offered by incumbent cable operators.

To reduce the costs of transitioning to a regime governed by a la carte or one of its other alternative pricing models, the Further Report suggests that only channels "carried in a digital format" be governed by one of these alternatives to current bundling practices.[70] Given that the controversy over MVPD pricing has focused almost entirely on prices charged for analog services, this is a rather curious suggestion. The pricing of digital tiers is little studied, so the factual foundation for even beginning an investigation of whether these prices merit the attention of policy makers is at best skimpy.

Putting aside the question of why cable operators' digital services should be a matter of concern, we should also consider the implications of these pricing proposals for the build out of the digital infrastructure in the United States. If forced implementation of one of these proposals would reduce MVPDs' profits from digital services, they would certainly have less incentive to promote them, which could slow consumer adoption. For the longer term, we have to ask how vulnerability to the possibility that rules governing pricing may be rewritten after investments in a more advanced infrastructure are already committed and sunk will impact incentives to invest in future upgrades.

VIII. Final Assessment of the Further Report

Has the Further Report advanced any credible arguments on behalf of a policy-mandated shift to a la carte, mixed bundling, themed tiers, or subscriber-selected tiers? In my opinion, not at all. When you boil down all that was said in the Further Report's 61 pages, the most that can be taken away that is the least bit favorable to the case for any of its proposed alternatives to current MVPD pricing practices is that while MVPD costs will increase, they may not increase by as much as was forecast by the FCC's First Report (although my analysis suggests costs increases likely will be substantial), and there is a theoretical possibility that consumers might benefit under one of the alternatives to current practices. (Or they might be hurt.) The Further Report provides not a shred of evidence as to how likely a positive outcome might be. Nor does it tell us how its woefully under-analyzed proposals might be implemented if enacted. My own analysis shows that economic efficiency and consumer interests could both suffer with each of them, and that each poses substantial if not insuperable administrative challenges. To use the Further Report as the foundation for laws or regulations changing the ways MVPDs price their services would not be unlike a bather jumping off a cliff at night hoping there is water below.

Has the Further Report made a convincing case that "its options for introducing consumer choice" merit more attention? As an academic exercise, I am all for it. New economic truths may be revealed even if the exercise makes no lasting contribution to policy for video industries. If the effort required a substantial commitment of federal resources, I would question the priorities motivating the allocation. While the Further Report makes

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[70] *Further Report,* p. 29.

strong claims of promise and potential, it introduced no new evidence and failed to rigorously analyze its own proposals, which my own analyses find problematic.

Has the Further Report contributed to a fuller understanding of the economics of pricing MVPD services? To this question, my response is a qualified yes. The bundling scenarios modeled in the Economic Appendix to the Further Report are clever and generate new insights. It is also appropriate to scrutinize the methodology and assumptions supporting the pricing predictions of the First Report. Unfortunately, in doing this the Further Reported misinterprets assumptions, stated quite clearly in the BAH Report on which the First Report relied, regarding audience losses likely to be suffered by basic cable networks under a la carte. More troubling is its failure to acknowledge the full correction reported by BAH to computational errors in the BAH report while employing a partial correction that strengthened its case for a la carte. The Further Report's interpretation of certain marketing studies relied on by the authors of the First Report is questionable at best and the Further Report appears to selectively ignore studies and evidence submitted in response to the Notice that do not support its arguments that the costs of a transition to a new pricing regime may not be so large. That the Further Report accuses the First Report of bias is ironic to say the least. If all these troubling aspects of the Further Report have not contributed to a belief that the case for a la carte or one of the Further Report's "options for introducing consumer choice" has more merit than it really does, then I think the Further Report has made a positive contribution to our understanding of the economics of MVPD pricing, and, ultimately, to a better foundation for policy development. Otherwise, I am not so sure.

As with motherhood, patriotism and the American way, it is difficult to argue against a proposal that promises to give consumers more choice. This, of course, is exactly why policy proposals cloaked in such terms merit more than usual scrutiny. This report applied such scrutiny to the cases for a la carte and the other pricing policies advanced in the Further Report and found they do not stand up to close examination.